

Navigating the RMBS Market: Value & Opportunity in One of the Largest Bond Markets

Brent A. Miller, CFA

*VP & Senior Portfolio Manager,
Securitized Products*



**Fort Washington
Investment Advisors, Inc.**

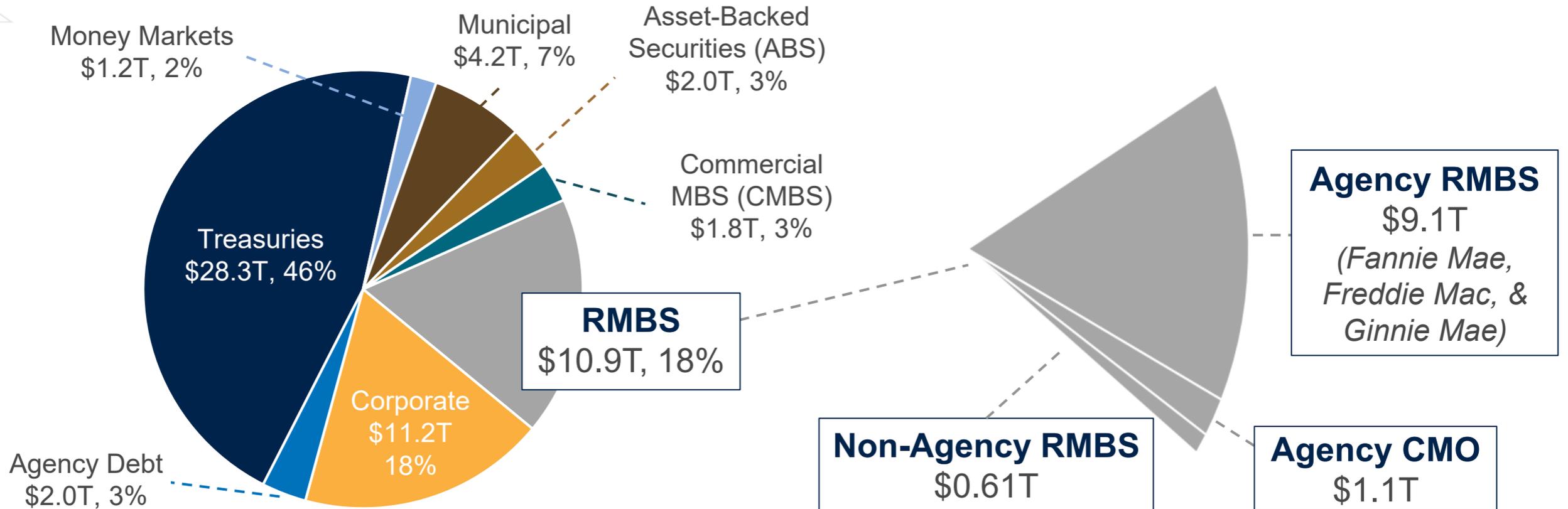
A member of Western & Southern Financial Group

Session Objectives

- ▶ Review the structure and evolution of the Residential Mortgage-Backed Securities (RMBS) market and its role within fixed income portfolios
- ▶ Explain how post-Global Financial Crisis (GFC) reforms reshaped RMBS underwriting, transparency, and risk profiles
- ▶ Explain why RMBS has re-emerged as an attractive asset class for institutional investors
- ▶ Highlight how RMBS can be used for diversification, income generation, and risk management

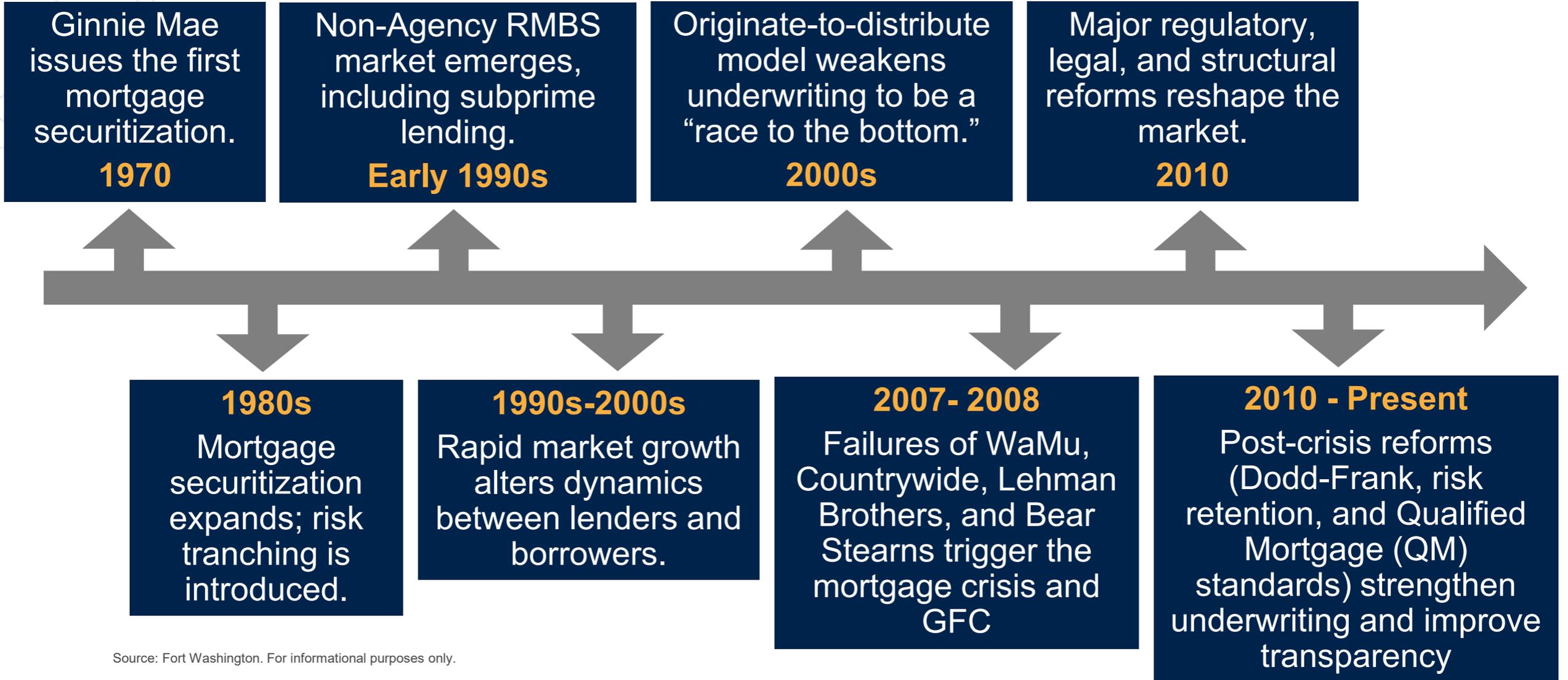
RMBS is a Large, Systemically Important Market

- ▶ Total U.S. bond market is over \$61 trillion.
- ▶ **RMBS represents 18% of the market**, the third largest bond market right behind Corporate Bonds.



Evolution of the RMBS Market

How the Market Developed:

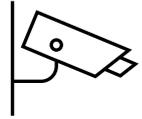


Source: Fort Washington. For informational purposes only.

RMBS Market Dynamics Today



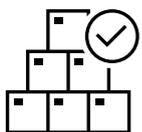
Increased Regulation	<ul style="list-style-type: none"> • Increased oversight • Dodd-Frank, CFPB • Qualified Mortgage Rule • Risk retention
-----------------------------	--



Increased Oversight	<ul style="list-style-type: none"> • Changes to capital requirement • Legal liability • SEC oversight
----------------------------	--



Increased Accountability	<ul style="list-style-type: none"> • Better collateral • Better structures • Greater data / transparency • Better alignment of interests
---------------------------------	--



Enhanced Structures	<ul style="list-style-type: none"> • Higher hard credit support • Less reliance on insurance wrap
----------------------------	---

Key Risk Mitigants vs. Pre-2008

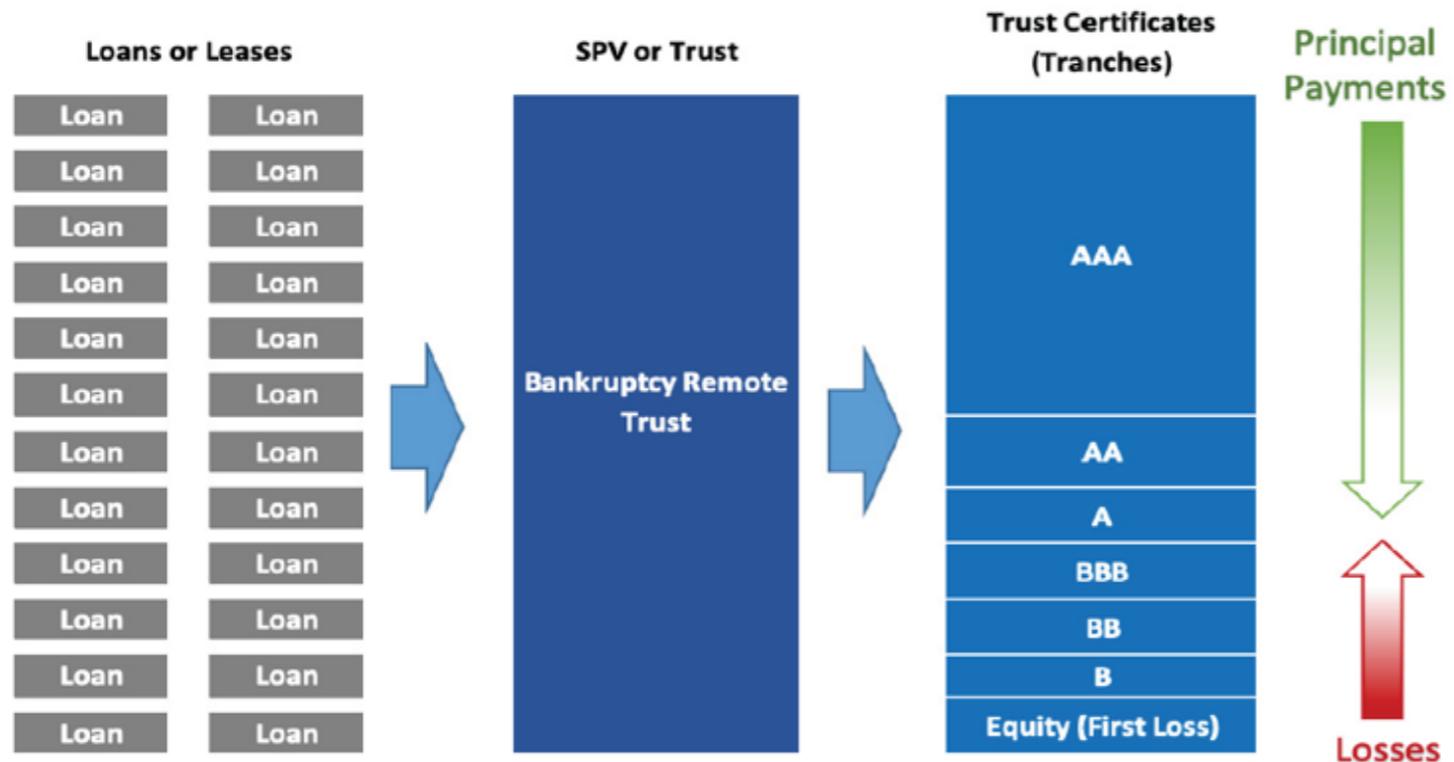
- ▶ 100% third-party due diligence on loan pools prior to issuance (vs. 5-10% pre-GFC)
- ▶ Automatic third-party review for repurchase and warranty violations on seriously delinquent loans
- ▶ 5% risk retention, typically held at the bottom of the capital stack
- ▶ Significantly higher enhancement levels:

	Today	Pre-Crisis
Prime Jumbo	15%	3-4%
Non-QM/Alt-A	25-35%	7%
Subprime	N/A	20-35%

What is Residential Mortgage Securitization?

How RMBS Works:

- ▶ Mortgage loans are pooled and transferred into a bankruptcy-remote trust
- ▶ The trust issues securities backed by the cash flows of the underlying loans
- ▶ Cash flows are distributed according to predefined legal rules



Role of Tranching:

- Securities are divided into tranches with differing priorities for principal repayment and loss allocation
- Senior tranches have first claim on cash flows and losses
- Tranching allows investors to select risk and return profiles

Source: Fort Washington. Tranches with higher credit ratings are senior in the capital structure of the trust and have first priority claims on trust assets.

Appeal of Securitization

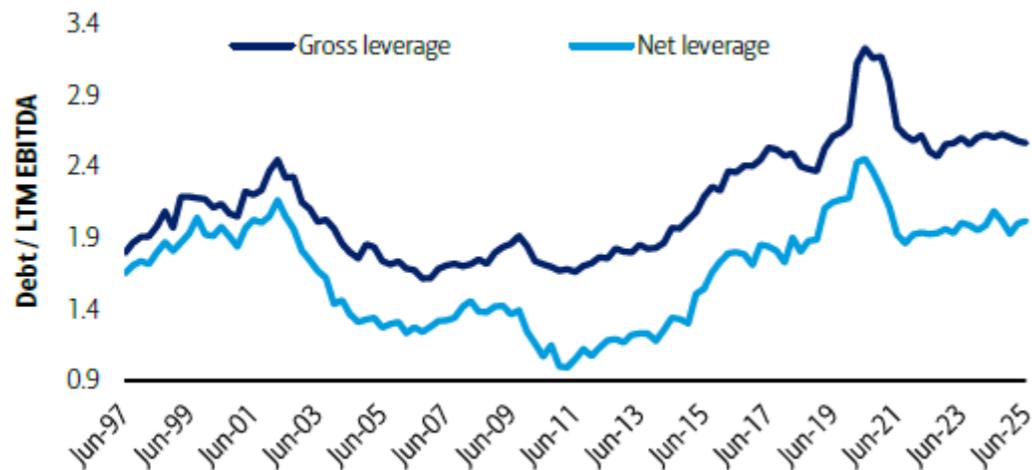
Why Investors Use Structured Credit:

- ▶ RMBS are secured by identifiable assets
- ▶ Monthly, loan-level data transparency
- ▶ Multiple layers of structural credit protection

Contrast With Corporate Bonds:

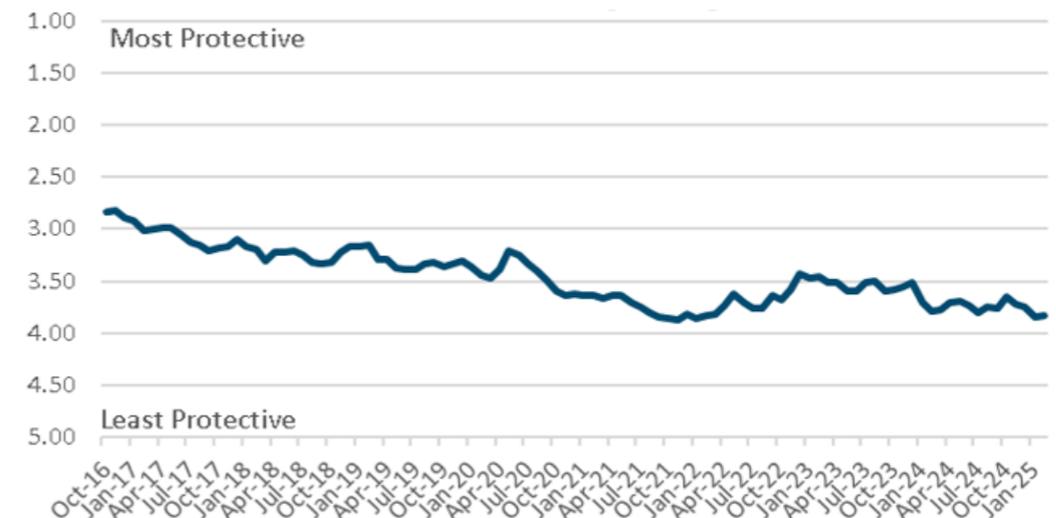
- Corporate bonds rely on issuer fundamentals
- More exposure to idiosyncratic corporate risk

BofA - Gross & Net Leverage (US IG, non-financial, non-utility)



Source: Fort Washington, Bank of America Research, Covenant Review. For informational purposes only.

Covenant Review – Composite Documentation Score (3mo Average)



Agency RMBS: How It Works

Core Characteristics

- ▶ Guaranteed by Government-Sponsored Enterprises (GSEs):
 - **Fannie Mae and Freddie Mac** — Implicit government support
 - **Ginnie Mae** — Explicit guarantee backed by the U.S. government
- ▶ Collateral consists primary of “Conforming Loans”, Qualified Mortgages (QM)
- ▶ Typically fixed-rate, first-lien mortgages

Primary Risks

- ▶ **Interest rate risk** — exposure through duration
- ▶ **Negative convexity** — cash flows tend to slow when rates fall and accelerate when rates rise

Structures

- ▶ Pass-through securities
- ▶ Collateralized Mortgage Obligations (CMOs) with customizable tranche structures
- ▶ Not callable

Agency RMBS: Risks And Opportunities

Current Market Environment

- ▶ High level of 30-year fixed mortgage rates (>6%) have slowed prepayments
- ▶ Increased cash flow predictability

Why Investors Use Agency RMBS:

- Large, highly liquid market
- Capital efficiency and leverage potential
- Yield and spread advantages vs. U.S. Treasuries
- Effective tool for expressing relative value vs. corporate credit
- Significant benchmark representation (24% of Bloomberg Agg.)

Key Risk to Monitor:

- Housing turnover and refinancing activity
- Interest rate volatility
- Supply and demand dynamics
- Federal Reserve & U.S. Government policy

Non-Agency RMBS: How It Differs

Core Characteristics

- ▶ No government guarantee
- ▶ Credit protection derives solely from deal structure and legal protections
- ▶ Typical issuers: banks, non-bank lenders, dealer conduits, REITs, and private asset managers

Common Collateral Types

- ▶ Prime Jumbo
- ▶ Non-Qualified Mortgage
- ▶ Non-Performing/Re-Performing
- ▶ Agency-Eligible Investor
- ▶ HELOCs/Closed-End Second Liens
- ▶ Reverse Mortgages

Primary Risks

- ▶ Interest rate risk, including negative convexity
- ▶ Credit and default risk

Structures

- ▶ Time-tranched deals with senior, mezzanine, and subordinate bonds
- ▶ Senior bonds often split into “current-pay” and “back-pay” pari passu tranches
- ▶ Issuers typically retain a cleanup call option to redeem

Non-Agency RMBS: Risks And Opportunities

Current Market Environment

- ▶ Strong housing fundamentals supported by limited supply, historic high homeowner equity, and favorable consumer credit
- ▶ Are offset by affordability challenges and regional housing disparities

Why Investors Use Non-Agency RMBS:

- Higher yield potential reflecting credit risk, lower liquidity, and structural complexity
- Direct exposure to U.S. housing with structural downside protection
- Opportunity for relative value and additional income versus Agency MBS and Corporate Bonds
- Opportunity for active alpha relative to traditional benchmarks (*BBG US Agg. or BBG US MBS*)

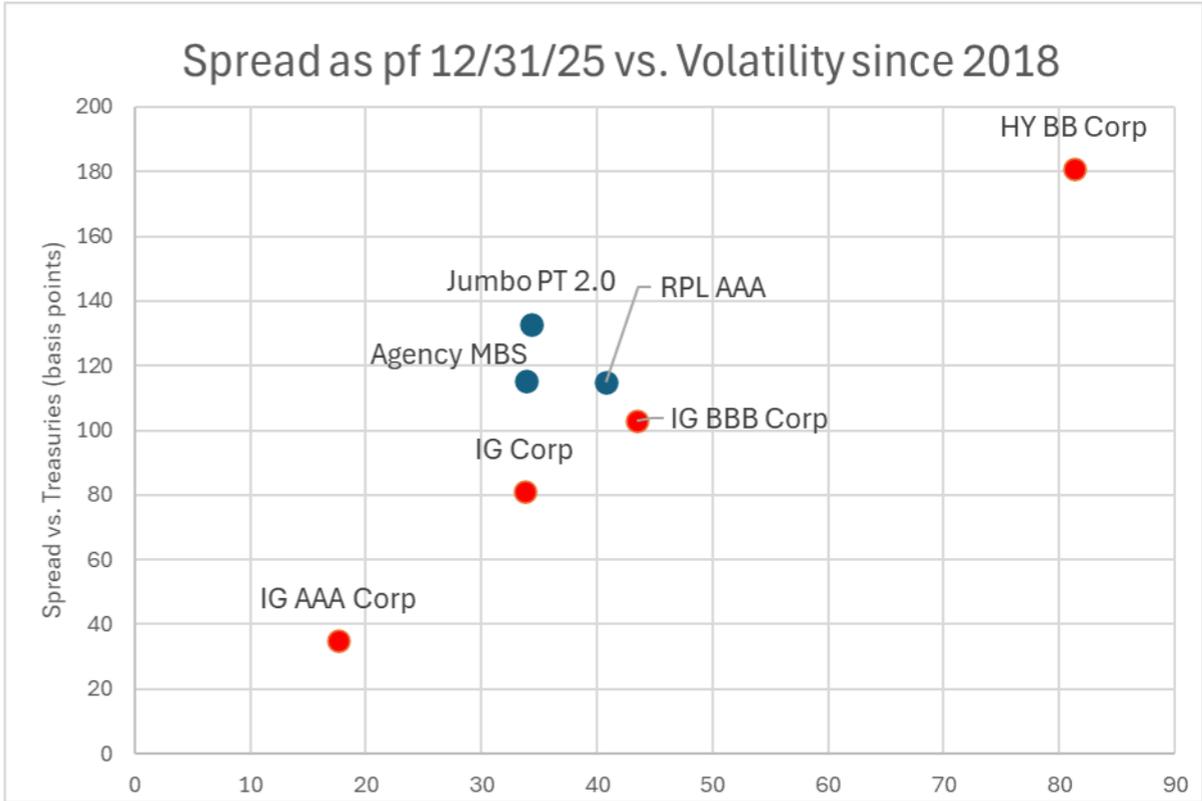
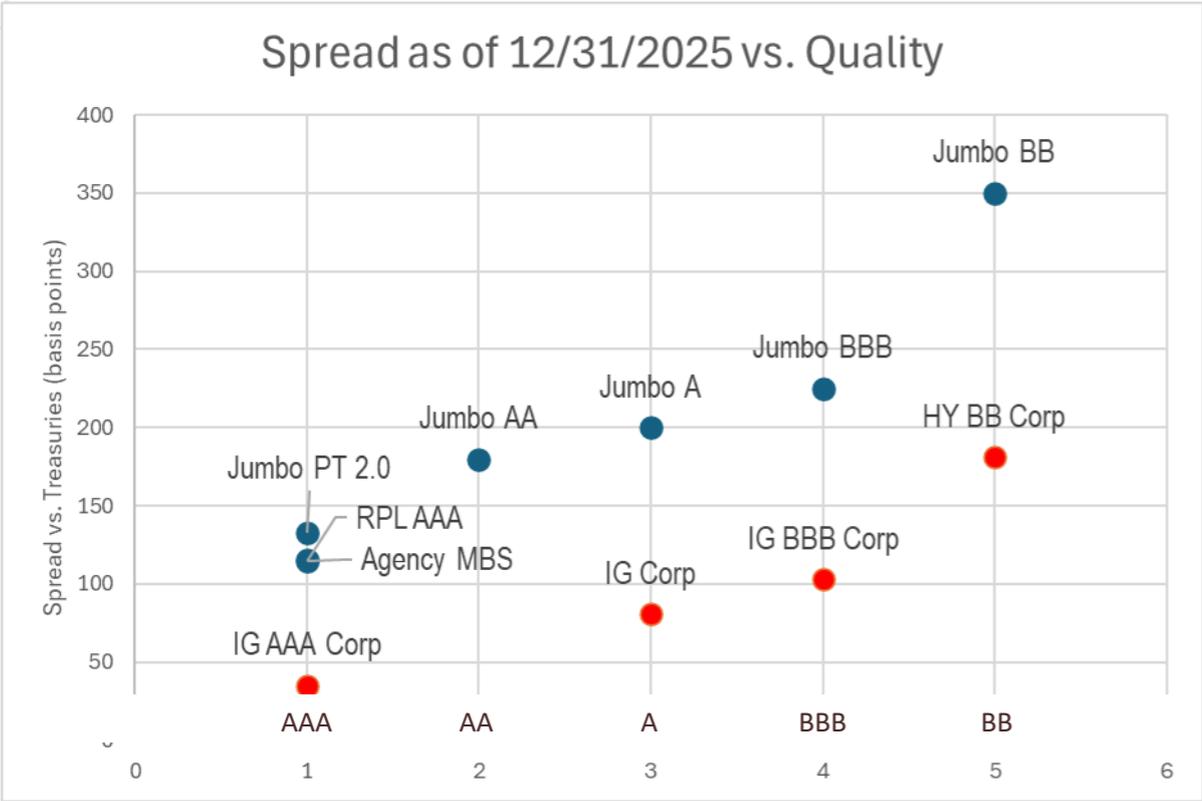
Key Risks to Monitor:

(In addition to factors that impact Agency RMBS)

- National/regional home prices
- Collateral quality and underwriting trends
- Delinquencies and roll rates
- Consumer credit conditions
- Mortgage servicer performance

Relative Value Advantage

- ▶ Nominal RMBS spreads offer meaningful pickup versus similarly rated corporate bonds
- ▶ Advantage persists after adjusting for spread volatility



Source: Fort Washington, Bank of America.

Non-Agency RMBS: Liquidity Premium

Why a Liquidity Premium Exists

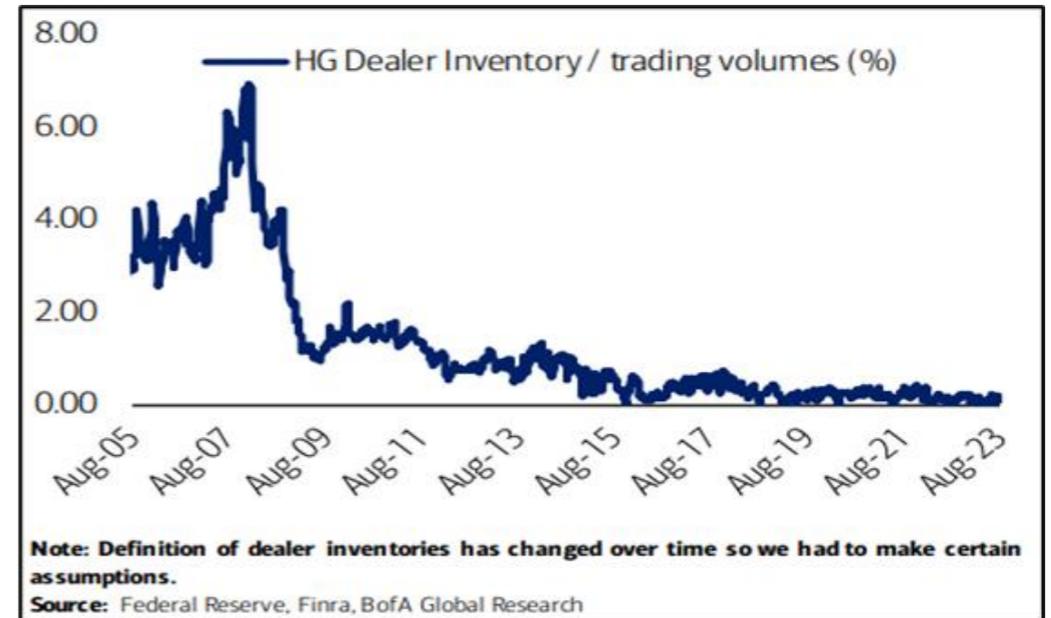
- ▶ **Fewer investors** — due to higher complexity (100s vs. 1,000s for corporate bonds).
- ▶ **Smaller markets** — typically \$10-\$80 billion (too small for large asset aggregators).
- ▶ **Reduced pricing transparency** — creates opportunity for knowledgeable and experienced investors.

Implications

- ▶ Investors are compensated for liquidity and complexity, not just credit risk
- ▶ In normal markets, liquidity is comparable to corporates
- ▶ During dislocations, corporates tend to recover faster and exhibit less volatility

Corporate Bond Market:

- Has a larger investor base but activity has reduced post-GFC due to policy change.



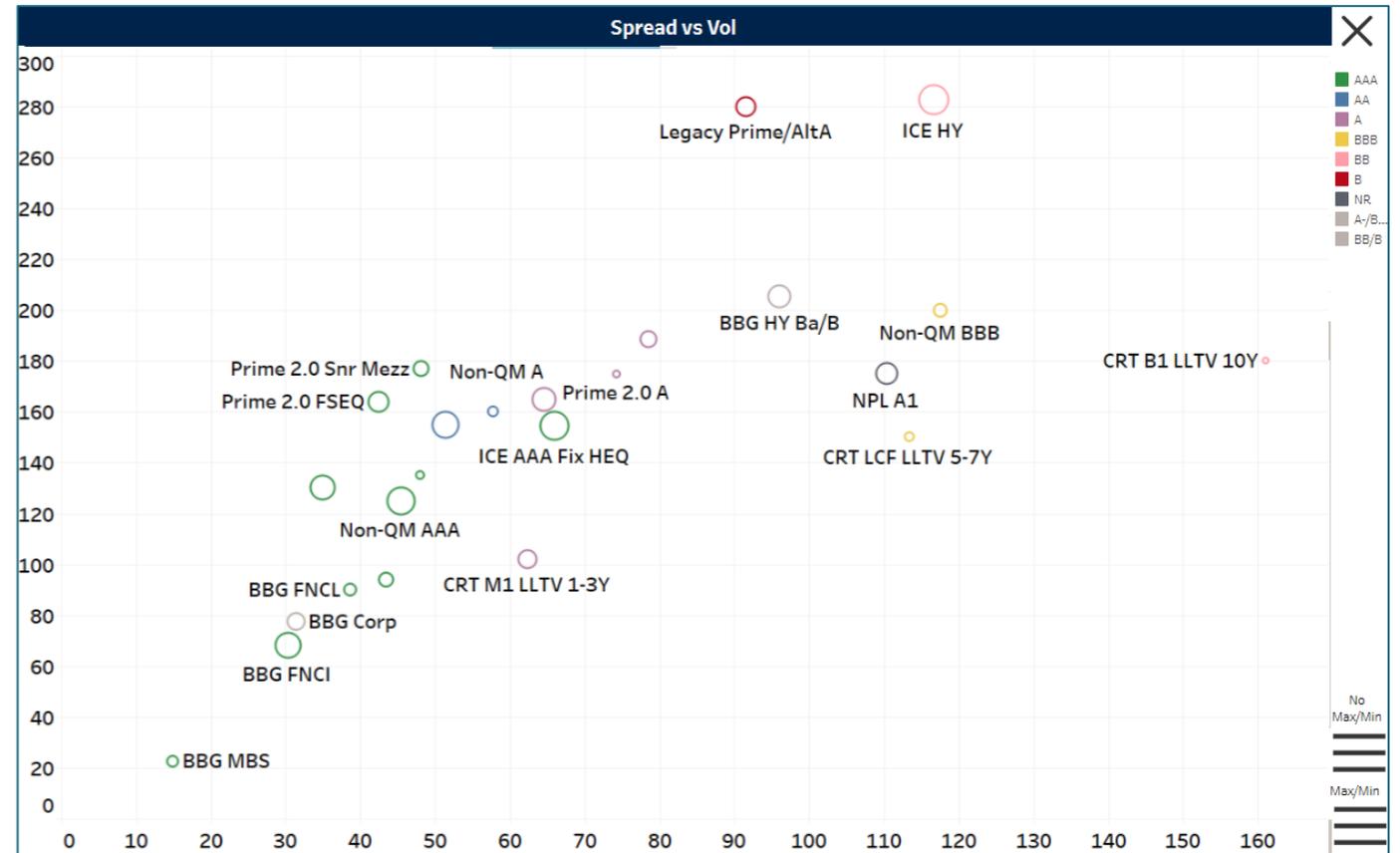
Non-Agency RMBS: Complexity Premium

Why Complexity Matters

- ▶ Requires deep experience and resources.
- ▶ Extensive loan-level data analysis, proprietary cash flow modeling, and structural analysis is needed.
- ▶ Understanding deal structure, collateral underwriting, and investor positioning is critical to performance.

Opportunity Created by Complexity

- ▶ Reduces the number of investors creating opportunity for specialized active managers.



How RMBS Enhances Fixed Income Portfolios

Benchmark Context

- ▶ Agency RMBS represent ~24% of the Bloomberg US Aggregate Bond Index
- ▶ Non-Agency RMBS are not represented, creating alpha potential

RMBS Can Be Used To

- ▶ Diversify away from corporate credit risk
- ▶ Improve risk-adjusted returns
- ▶ Fine-tune duration, convexity, cash flow, and credit exposure
- ▶ Gain exposure to U.S. housing with structural credit protection and downside mitigation

Portfolio Applications

Asset-Liability Management:

- ▶ **Weighted Avg Maturity** — AAA tranches typically range from 2.5-11.5 years; lower-rated tranches generally exceed 7 years.
 - Underlying loans amortize, while tranches can be structured with lockouts and tighter maturity windows.
- ▶ **Optionality** — Cleanup call typically exercised at 10% of original loan balance.
- ▶ **Coupon** — Predominately fixed-rate.
- ▶ **Capital Treatment** — Senior bonds generally receive favorable regulatory capital treatment.

Total Return:

- ▶ **Short Duration** — Seasoned AAA Non-Agency RMBS currently offering 50-100 bps spread pickup over IG Corporates
- ▶ **Core/Core Plus** — Agency RMBS combined with AAA–A Non-Agency RMBS offer convexity benefits and 80-100 bps spread advantage over the Bloomberg US MBS Index
- ▶ **Opportunistic Fixed Income** — Diversified AA–BB RMBS portfolios targeting high-quality high-yield corporate-like returns with lower volatility

Implementation: Accessing RMBS

Why Active Management Matters

- ▶ Essential due to complexity and less-transparent markets
- ▶ Deal-level analysis drives outcomes
- ▶ Structure selection is critical
- ▶ Market inefficiencies favor specialized experience in RMBS and securitized assets to provide:
 - A scale advantage through deep asset-specific teams driving research and risk management
 - Specialized and proprietary resources to improve sourcing, analysis, and management

Implementation Options

- ▶ Separate accounts for larger mandates
- ▶ Funds or ETFs for smaller allocations

Key Takeaways

- ▶ RMBS is a large, diverse, flexible, and established segment of the fixed income market.
- ▶ Today's RMBS market is fundamentally different from pre-2008
- ▶ Agency and Non-Agency RMBS serve distinct but complementary roles
- ▶ Current housing and mortgage dynamics present both opportunity and risk.
- ▶ When used appropriately, RMBS can enhance portfolio efficiency without increasing overall risk



Any Questions?